Supreme Court, U. S.
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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1978

No. 78-401

GAVIN S. MILLAR, PHILIP D. RODGERS and ELIZABETH C. RODGERS, JAMES L. TENLEY and BETTY J. TENLEY, ROBERT K. CONRAD and JANE H. CONRAD,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

DAVID B. BUERGER
WILLIAM Y. RODEWALD
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OPINION BELOW

The petitioners Gavin S. Millar, Philip D. Rodgers and Elizabeth C. Rodgers, James L. Tenley and Betty J. Tenley, and Robert K. Conrad and Jane H. Conrad, respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on June 12, 1978.

The opinion of the Court of Appeals, of which review is sought, appears at 577 F.2d 212 (3rd Cir. 1978) and in 1978-2 U.S.T.C. ¶9514. The original opinion rendered by the Tax Court in this proceeding appears at Docket Nos. 5884-72 to 5893-72 (filed April 22, 1975) and in 34 T.C.M. 554. The opinion of the Court of Appeals, vacating and remanding for further proceedings the aforesaid decision of the Tax Court, appears at 540 F.2d 184 (3d Cir. 1976) and in 1976-2 U.S.T.C. ¶9611. The Supplemental Opinion of the Tax Court rendered upon remand appears at 67 T.C. 647 (1977). The foregoing opinions are set forth in full in the Appendix to this Petition.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on June 12, 1978 and this Petition for Certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

1. If the value of encumbered property is less than the amount of the debt to which the property is subject, and the owner is not personally liable on the debt, does the owner upon sur-

render of the property to the creditor realize taxable income?

2. Has the Court of Appeals decided a federal question in a way in conflict with applicable decisions of the Supreme Court, when it specifically notes a clear statement of federal income tax law in a Supreme Court opinion, but "declines to accept" that view of the law in deciding the present case?

3. Has a Court of Appeals, which "declines to accept" an admittedly important principle of tax law as clearly stated by the Supreme Court, so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of the Supreme Court's power of supervision?

STATUTORY PROVISIONS INVOLVED

United States Code, Title 26

§1001(a)

COMPUTATION OF GAIN OR LOSS. - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

§1001(b)

AMOUNT REALIZED. - The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received....

§1001(c)

RECOGNITION OF GAIN OR LOSS. - Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

STATEMENT OF THE CASE

The Taxpayers were among the ten shareholders of Grant County Coal Corporation ("Grant County") organized in 1964 by R. N. Jamison, Jr., an experienced coal operator. To obtain operating funds for Grant County, Jamison personally borrowed a total of $500,000 from Mellon National Bank & Trust Co. ("Mellon Bank") from 1964 through 1965 and Jamison advanced the full amount to the shareholders, who made corresponding contributions to Grant County. The shareholders gave Jamison non-recourse demand notes secured only by their Grant County stock.

Despite the acknowledged intent of all concerned that Grant County should make a profit, it sustained net operating losses. The shareholders reported their pro rata shares of the net operating losses in their individual federal income tax returns for the years 1964, 1965 and 1966 pursuant to a timely election and consents filed under Subchapter S of the Internal Revenue Code of 1954 ("Code"). In January, 1967, Grant County filed a petition under Chapter 11 of the Bankruptcy Act. Jamison then notified the shareholders that he was foreclosing upon their pledged stock, which was then completely worthless, and each of them acknowledged the foreclosure in writing. Shortly thereafter, Grant County was adjudicated bankrupt.

In their federal income tax returns for 1967, the Taxpayers reported neither

gain nor loss from the foreclosure on their worthless stock. The Internal Revenue Service subsequently determined deficiencies for the year 1967 on the theory that the foreclosure had caused a realization of income.

The Tax Court held that the Taxpayers had realized taxable capital gain in the amount by which their non-recourse indebtedness exceeded their adjusted basis of the stock. The Third Circuit remanded the case to the Tax Court to consider, inter alia, how to apply this Court's opinion in Crane v. Commissioner, 331 U.S. 1 (1947) in view of the fact that the Taxpayers' non-recourse debt exceeded the fair market value of the pledged stock. The Court noted "the general importance of this issue to the tax law." (p. 30a). In a Supplemental Opinion, the Tax Court held that the Taxpayers realized gain upon foreclosure despite the total worthlessness of the stock. The Court of Appeals affirmed the judgment of the Tax Court stating that it "declines to accept" the clear and diametrically opposite statement of the tax law as set forth by this Court in footnote 37 of Crane.

REASONS FOR GRANTING THIS WRIT

In Crane v. Commissioner, 331 U.S. 1, 14 (1947), this Court held that "a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot" and

hence must include the amount of the mortgage in the "amount realized" from the sale. That holding was based on the economic substance of the transaction:

> We are . . . concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

As an integral part of the legal analysis leading to its holding in Crane, this Court carefully and explicitly pointed out that the opposite result would follow, and no income would be realized, if the value of the property is less than the amount of the debt (footnote 37 at p. 14):

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. This is not the case.

That is, however, the present case. The importance of footnoote 37 to the tax law is indicated by the extensive discussion and commentary devoted to the principle therein expressed.* The Court of Appeals for the Third Circuit nevertheless "declines to accept" what this Court considered to be an obvious tax result, and held that the Taxpayers realized a taxable benefit equal to the debt, even though the debt was vastly greater than the zero value of the property.

---

* See, e.g., Bittker, Tax Shelters, Non-Recourse Debt, and the Crane Case, 33 Tax L.Rev. 277 (1978); McGuire, Tax Shelter Partnerships - Liabilities in Excess of Basis, 36 N.Y.U. Inst. Fed. Tax 1443 (1978); McGuire, Some Observations on Millar (not yet published article 1978); Johnson, Tax Models for Non-Recourse Employee Liability, 32 Tax L.Rev. 359 (1977); Gallagher, Fiscal Alchemy and the Crane Rule: Alternative Solutions to the Tax Shelter, 8 Conn. L.Rev. 607 (1976); Handler, Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee, 31 Tax L.Rev. 193 (1976); Rabkin and Johnson, FEDERAL INCOME, GIFT AND ESTATE TAXATION, Sec. 36.06(3) (1976); Ginsberg, The Leaky Tax Shelter, 53 Taxes 719 (1975); Landis, Liabilities and Purchase Price, 27 Tax Law. 67 (1973); Blatner, Debt Cancellation, 30 N.Y.U. Inst. Fed. Tax 237 (1972); Perry, Limited Partnerships and Tax Shelters: The Crane Rule Goes Public, 27 Tax L.Rev. 525 (footnote cont.)

Both before and after Crane, this Court has set limits consistent with footnote 37 on the concept of realization for tax purposes. Thus, in Bowers v. Kerbaugh-Empire Company, 271 U.S. 170 (1926), the taxpayer borrowed German marks, lost the borrowed money in business, and turned over greatly depreciated marks in satisfaction of the loan. This Court held that the repayment did not produce income, pointing out (p. 175): "The result of the whole transaction was a loss." Similarly, in the present case, the Taxpayers borrowed money, lost the borrowed money in business, and turned over greatly depreciated stock in satisfaction of the loan. In each case "The result of the whole transaction was a loss," and in each case no taxable income should result.

(Footnote cont.)

(1972); Anderson, Tax Factors in Real Estate Operations, 197 (3d ed. 1969); Del Cotto, Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing, 118 U.Pa. L.Rev. 69 (1969); McGuire, Negative Capital Accounts and the Failing Tax Shelter, 3 J. Real Estate Tax, 439 (1967); Adams, Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion, 21 Tax L.Rev. 159 (1966); Spears, Mortgages in Excess of Basis, 1959 So. Calif. Tax Inst. 833; Lurie, Negative Equities and Negative Bases, 10 N.Y.U. Inst. Fed. Tax 86 (1952).

And in United States v. Davis, 370 U.S. 65 (1962) gain on the exchange of a husband's stock for his wife's marital rights (having no ascertainable value) was computed on the value of the husband's stock - on the very practical assumption that what he gave had the same value as what he got. Similarly, in the present case, the "amount realized" by the Taxpayers was the same as what they gave up - and all the Taxpayers gave up was the admittedly worthless stock. Section 1001 of the Code taxes gains computed by reflecting "any money received plus the fair market value of the property ... received," but these Taxpayers received no money and no property. When the Taxpayers surrendered their worthless stock, and were not relieved of any debt on which they were personally liable, they were no better off than before they surrendered the stock.

Despite the Commissioner's attempt to disregard footnote 37 in this case, the Internal Revenue Service is quite willing (when it suits its revenue-gathering purposes) to apply the very same Crane tax realization analysis stated by the Supreme Court and here urged by the Taxpayers. In Revenue Ruling 77-110, 1977-1 C. B. 58, dealing with the basis of property acquired subject to a non-recourse debt, the taxpayer could not demonstrate that the value of the property was as great as the debt. The Service ruled that the debt could therefore not be reflected in basis, reasoning (Id. at 59) that when pledged property is worth less than the

amount of the non-recourse debt, the owner lacks the requisite "economic incentive to treat the obligation as if it were a personal obligation." This is the reasoning and indeed the very language of Crane which the Service and Court of Appeals have declined to accept in this case.

Several false issues should also be put to rest. First, the Court of Appeals attempted to justify its refusal to follow the Crane footnote on the ground that the Taxpayers would be getting "double deductions" (p. 7 a). Quite the contrary is true: the Taxpayers as shareholders of a Subchapter S corporation did deduct - once - their share of its losses, but have not claimed any second deduction. If they are now taxed on a fictitious gain, they will lose the one deduction taken. So, if the Taxpayers are taxed as proposed, then no taxpayer will ever get even a single deduction for those business losses of more than half a million dollars. Second, this case does not involve any tax shelter or tax "dodge." It is agreed that all parties hoped and expected that the business would make economic and taxable profits, and the losses came as a surprise and disappointment to all concerned.

In this case the Service seeks to recapture deductions, properly taken by the Taxpayers as shareholders of a Subchapter S corporation, despite the absence of any statutory provision for such recapture. The Congress knows how

to enact recapture provisions.** The Court of Appeals has nevertheless ignored the basic statutory provisions governing realization of gain in order to accomplish a recapture by judicial fiat. This Court has clearly and correctly set forth the law. If a change is to be made in that law, it must be carefully legislated by Congress; it should not be created by a lower court which "declines to accept" this Court's statement of the law and chooses instead to attempt judicial amendment of the Code.

** See, e.g., Code Sections 47, 80, 176, 617(d), 1238, 1245, 1250, 1252, 2016.

CONCLUSION

Because the Court of Appeals decided an important question of federal tax law in a way in conflict with this Court's decision in Crane and thus so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision, a writ of certiorari should issue to review the judgment and opinion of the Third Circuit.

Respectfully submitted,

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September 8, 1978

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 77-1926

GAVIN S. MILLAR

v.

COMMISSIONER OF INTERNAL REVENUE
(Tax Court Docket No. 5884-72)

PHILIP D. RODGERS and ELIZABETH C. RODGERS, his wife

v.

COMMISSIONER OF INTERNAL REVENUE
(Tax Court Docket No. 5888-72)

JAMES L. TENLEY and BETTY J. TENLEY, his wife

v.

COMMISSIONER OF INTERNAL REVENUE
(Tax Court Docket No. 5892-72)

ROBERT K. CONRAD and JANE H. CONRAD, his wife

v.

COMMISSIONER OF INTERNAL REVENUE
(Tax Court Docket No. 5893-72)

Gavin S. Millar (Petitioner, T.C. No. 5884-72), Philip D. Rodgers and Elizabeth C. Rodgers (Petitioners, T.C. No. 5888-72), James L. Tenley and Betty J. Tenley (Petitioners, T.C. No. 5892-72), Robert K. Conrad and Jane H. Conrad (Petitioners, T.C. No. 5893-72),
Appellants

APPEAL FROM THE UNITED STATES TAX COURT

Argued February 23, 1978

Before: ADAMS, HIGGINBOTHAM, *Circuit Judges*, and BECHTLE, *District Judge* *

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OPINION OF THE COURT

(Filed June 12, 1978)

BECHTLE, *District Judge*

In this appeal from a redetermination by the Tax Court, the issues presented are: (1) whether funds received by the taxpayers [1] from R. H. Jamison, Jr. ("Jamison"), were loans rather than gifts; and, (2) whether the tax-

* Honorable Louis C. Bechtle, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

1. Four of Grant County's original shareholders are not parties to this appeal. Hereinafter, the term "shareholder" shall refer to all of Grant County's original shareholders, and the term "taxpayer" only to the shareholders involved in this appeal.

payers realized taxable gain in the form of cancellation of indebtedness upon surrender of their stock in the Grant County Coal Corporation ("Grant County") in complete satisfaction of their nonrecourse obligations, which were secured solely by the stock, even though at the time of surrender the stock had a value less than the value of the nonrecourse obligations. For the reasons stated below, we conclude that the funds received by the taxpayers from Jamison were loans rather than gifts and that the taxpayers realized taxable gain when their Grant County stock was surrendered to Jamison in complete satisfaction of their nonrecourse obligations. However, we agree with taxpayers Robert K. and Jane H. Conrad ("Conrads") that no penalty should be imposed for failure to recapture previously claimed investment credits. Accordingly, we will affirm the decision of the Tax Court on all issues, except the imposition of a penalty pursuant to 26 U.S.C. § 6653(a), which shall be stricken.

The facts of this case are reported fully in *Millar v. Commissioner,* 540 F.2d 184 (3d Cir. 1976), wherein we remanded to the Tax Court for an initial determination of the issues presented in this appeal. Upon remand, the Tax Court decided that the funds were received in the form of a loan and that the taxpayers had realized taxable gain. The taxpayers appeal both of those determinations.

We find no reason to disturb the Tax Court's determinations. First, upon receipt of the funds from Jamison, the taxpayers executed nonrecourse demand notes which bore an interest rate of five and one-half percent and which were secured solely by the taxpayers' Grant County stock. The taxpayers claimed their *pro rata* share of the interest payments on these notes when calculating their federal income taxes for the years 1964 through 1966. The taxpayers then executed an assignment of their stock to Jamison, who in turn assigned the shareholders' notes and stock assignments to the Mellon National Bank and Trust Company of Pittsburgh ("Mellon Bank") as additional

security on a $500,000 loan previously secured by Jamison. Finally, on January 27, 1967, after Grant County had filed a petition to reorganize under Chapter 11 of the Bankruptcy Act, each taxpayer signed an acknowledgment that Jamison had demanded payment on the notes and, no payments having been received, had foreclosed upon their Grant County stock. The formalities undertaken by the taxpayers upon receipt of the funds from Jamison and the activities engaged in by them in connection with the funds clearly support the Tax Court's determination that the funds received from Jamison by the taxpayers were loans rather than gifts.

Second, in finding that the taxpayers realized taxable income when their Grant County stock was surrendered to Jamison in complete satisfaction of their nonrecourse obligations, the Tax Court relied upon the Supreme Court's holding in *Crane v. Commissioner*, 331 U.S. 1 (1947), that: (1) the basis of property subject to a mortgage includes the amount of the mortgage, even though the owner of the property assumes no liability on the mortgage debt; and, (2) when such property is sold, the "amount realized" includes the amount of the unassumed mortgage. The taxpayers, on this appeal, argue that the Tax Court erred when it determined that they had realized taxable gain as a result of the foreclosure and surrender of the stock, because the value of the stock surrendered was less than the value of the note foreclosed upon. In support of their arguments, the taxpayers rely exclusively upon footnote 37 of the *Crane* opinion, wherein the Supreme Court said:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

Crane v. Commissioner, supra, 331 U.S. at 14, n.37. We must determine, therefore, whether footnote 37 of *Crane* creates an exception to the principal holding of *Crane* which would relieve the taxpayers of the otherwise taxable consequences of this exchange. We find that it does not and that the reasoning and analysis of the *Crane* opinion squarely sustain the imposition of tax liability in this case.

In *Crane v. Commissioner, supra*, the taxpayer, as the sole beneficiary of her deceased husband, acquired depreciable property in the form of an apartment building and lot which, at the time of acquisition, was subject to a mortgage upon which the taxpayer was not personally liable. As of the date of the inheritance, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. During the time that the taxpayer owned the property, she reported the gross rentals as income and claimed deductions for taxes, operating expenses, interest paid on the mortgage and for the physical exhaustion of the building. Seven years after acquiring the property, the taxpayer sold the property to a third party for $3,000 cash, subject to the mortgage and paid $500 expenses of sale. She thereafter reported a taxable gain of $1,250.

In calculating the tax liabilities resulting to the taxpayer as a result of this sale, the Supreme Court held, *inter alia*, that the amount of the mortgage was properly included in the amount realized for purposes of computing the gain or loss resulting therefrom. §§ 111(a), (b) of the Revenue Act of 1938, as amended, 26 U.S.C. §§ 1001(a), (b) (1954).[2] Thus, in *Crane*, the gain realized by the taxpayer as a result of the sale was not only the cash receipts, but also the prin-

2. Section 111 of the Revenue Act of 1938, as amended, 26 U.S.C. § 1001 (1954), states, in pertinent part:

> (a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

cipal amount of the mortgage subject to which the property was sold, less the adjusted basis of the property. *Crane v. Commissioner, supra,* 331 U.S. at 11, 13-14, § 113(b) of the Revenue Act of 1938, *as amended,* 26 U.S.C. § 1011. In so ruling, the Supreme Court noted that:

> The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. . . .

Crane v. Commissioner, supra, 331 U.S. at 15-16 (footnote omitted).

While the facts of the instant case are distinguishable from those in *Crane,* the principal reasoning of the Supreme Court in reaching its determination applies equally well to the facts of the case before us. In this case, the taxpayers' basis in the Grant County stock received from Jamison was equal to their cost, which was zero. 26 U.S.C. § 1012. The loan funds received by the taxpayers from Jamison increased the basis in their respective stock by the amount of the total money each contributed to Grant County's capital, for a total tax basis of $245,000. 26 U.S.C. § 1016. This basis of $245,000 was reduced by the amount of the interest and net operating loss deductions claimed by the taxpayers, which resulted in a total adjusted basis in the stock of $39,492 by the end of 1966. The total outstanding nonrecourse indebtedness of the taxpayers, which for the taxpayers before us amounted to $245,000, thus exceeded the total adjusted basis in the stock by $205,508. The Commissioner determined that the surrender of stock, in exchange for the cancellation of the nonrecourse obligation which resulted from the foreclosure, amounted to a gain to the taxpayers in the amount of $205,508, or the amount by which the value of the nonrecourse obligation satisfied by the foreclosure exceeded the adjusted basis of the stock. 26 U.S.C. §§ 1001(a), (b). In calculating this gain, the Commissioner relied upon *Crane, supra,* to find that the amount realized by the taxpayers upon this exchange included the value of the nonrecourse obligation, even though the taxpayers were not personally liable for that obligation.

This finding is totally in keeping with the spirit and reasoning of *Crane.* While not personally liable upon the loan from Jamison, the taxpayers utilized those funds to increase the basis of their stock, which then permitted them to claim sizable deductions calculated against that basis. *See* 26 U.S.C. §§ 163, 1374(a), (b). Having substantially reduced the adjusted basis of their stock in this manner and thereafter surrendering their devalued stock in exchange for the cancellation of their indebtedness, the taxpayers clearly realized taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock. A finding that the taxpayers did not realize gain as a result of this exchange, after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane.*

Footnote 37, if taken literally, might furnish support for the taxpayers' argument that the Supreme Court carved out an exception in the *Crane* holding in circumstances where the value of the property surrendered or exchanged is less than the value of the nonrecourse obligation which is satisfied. However, this Court declines to accept a literal reading of that footnote as the principal basis upon which this case should be decided. This disinclination is intended not as a determination that the footnote has little or no value in the analysis of the instant case, but rather as a conclusion that, in the analysis of this problem, the footnote should be evaluated in the proper context. First, it must be remembered that the footnote in *Crane* was *dictum.* Furthermore, the footnote was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances.

Viewed in that perspective, we believe that the rationale of the Supreme Court's principal reasoning, analysis and holding in *Crane* is more clearly the measure by which the transaction *sub judice* should be decided. Thus, applying *Crane* to the facts of the case before us, it is clear that the transaction resulted in taxable gain to the taxpayers by reason of the inclusion of the nonrecourse obligation in the calculation of basis as well as the amount realized when computing the presence or absence of gain resulting to the taxpayers from the foreclosure of the notes and surrender of the stock. Accordingly, we will sustain the findings of the Tax Court on this issue.

Finally, although we affirm the Tax Court's determination that the previously claimed investment credits were subject to recapture, pursuant to 26 U.S.C. §§ 38, 48(e), we find that the record does not justify imposition of a penalty upon the Conrads pursuant to 26 U.S.C. § 6653(a). We cannot find that, in light of the complex issues and confusion resulting from the bankruptcy of Grant County, note foreclosure and stock surrender, the record supports a finding that the Conrads' failure to recapture the investment credits previously claimed by them was due to negligence or intentional disregard of tax rules and regulations.

The Order of the Tax Court will be affirmed on all issues except the imposition of a penalty pursuant to 26 U.S.C. § 6653(a), which shall be stricken.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

(A.O. U. S. Courts, International Printing Co., Phila., Pa.)

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 77-1926

GAVIN S. MILLAR

vs.

COMMISSIONER OF INTERNAL REVENUE

(T.C. Docket No. 5884-72)

PHILLIP D. RODGERS and
ELIZABETH C. RODGERS, his wife

vs.
COMMISSIONER OF INTERNAL REVENUE

(T.C. Docket No. 5888-72)

JAMES L. TENLEY and
BETTY J. TENLEY, his wife

vs.
COMMISSIONER OF INTERNAL REVENUE

(T.C. Docket No. 5892-72)

ROBERT K. CONRAD and
JANE H. CONRAD, his wife

vs.
COMMISSIONER OF INTERNAL REVENUE

(T.C. Docket No. 5893-72)

Gavin S. Millar, Philip D. Rodgers,
Elizabeth C. Rodgers, James l. Tenley
Betty J. Tenley, Robert K. Conrad
and Jane H. Conrad,
Appellants

(T.C. Docket Nos. 5884-72, 5888-72
5892-72 and 5893-72)

ON APPEAL FROM A DECISION OF THE
UNITED STATES TAX COURT

Present: ADAMS and HIGGINBOTHAM, Circuit Judges and BECHTLE, District Judge*

J U D G M E N T

This cause came on to be heard on the record from the United States Tax Court, and was argued by counsel on February 23, 1978.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed on all issues except the imposition of a penalty pursuant to 26 U.S.C. §6653(a). As to the imposition of a penalty, the order of the Tax Court be, and the same is vacated, and the penalty imposed be and the same is hereby stricken, all of the above in accordance with the opinion of this Court.

ATTEST:

/s/ Thomas E. Quinn
Clerk

June 12, 1978

* Honorable Louis C. Bechtle, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

GAVIN S. MILLAR, ET AL.,/1 PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos.
5884-72,
5885-72,
5888-72,
5889-72,
5892-72,
5893-72.

Filed January 10, 1977.

Edmund W. Ridall, Jr., and R. K. Conrad, for the petitioners.

Joseph M. Abele, for the respondent.

SUPPLEMENTAL OPINION

QUEALY, Judge: In our opinion filed April 22, 1975 (T.C. Memo 1975-113), the Court held that the basis of petitioners in the stock of Grant County Coal Corp., a subchapter S corporation, for purposes of determining the deductibility by its shareholders of losses sustained by the corporation, should include the sum of $500,000 contributed to the corporation on behalf of its shareholders by R. H.

/1 Cases of the following petitioners are consolidated herewith: John R. Jamison and Suzon G. Jamison, docket No. 5885-72; Philip D. Rodgers and Elizabeth C. Rodgers, docket No. 5888-72; Philip R. Jamison and Helen L. S. Jamison, docket No. 5889-72; James L. Tenley and Betty J. Tenley, docket No. 5892-72; and Robert K. Conrad and Jane H. Conrad, docket No. 5893-72.

Jamison, Jr., in the form of loans evidenced by nonrecourse notes in the amount of the respective contributions by each shareholder, payment of which was secured solely by a pledge of their respective shares. In so holding, this Court stated that with respect to this issue the result would be the same whether advances are treated as a "debt" or as "gifts."

On appeal, the U.S. Court of Appeals for the Third Circuit remanded the case in order that the Tax Court might determine whether the amounts contributed to the capital of the corporation by or on behalf of the petitioners constituted loans from R. H. Jamison, Jr., or whether such amounts should be treated as gifts by him to the petitioners. Millar v. Commissioner, 540 F.2d 184 (3d Cir. 1976). In the event that this Court should determine, on remand, that the amounts contributed to the capital of the corporation constituted "loans" to the petitioners, the Court of Appeals requested that this Court consider the question whether the discharge of nonrecourse obligations should be included in the amount realized from the sale or other disposition of the stock by petitioners where the fair market value of such stock is less than the amount of the debt which was extinguished.

In the trial of the case before the Tax Court, petitioners did not contend that the amounts purportedly "loaned" to them by Mr. Jamison should be treated as gifts. On the contrary, petitioners were given an opportunity to present the testimony of R. H. Jamison, Jr., for the purpose of raising the issue

and declined to do so. In petitioners' brief, the Tax Court was requested to find the following:

> (1) Grant was a West Virginia business corporation, electing Internal Revenue Code subchapter S treatment, and petitioners were Grant shareholders consenting to such election (Stip. pars. 11 and 12).
>
> (2) Since August 1, 1964, petitioners were, and even now continue to be, shareholders of Grant (Stip. pars. 30 and 33).
>
> (3) From July 28, 1964, to December 20, 1965, petitioners borrowed $500,00 from Jamison and forwith paid the total thereof into Grant as capital to be used for corporate purposes (Stip. pars. 26 and 27).
>
> (4) As security for Jamison's loans to petitioners, demand, promissory, nonrecourse notes were signed by petitioners and their Grant stock was assigned by petitioners to Jamison by separate stock powers, as collateral to their notes (Stip. pars. 26, 27, 31).

Again, in the same brief under the title "Did R. H. Jamison, Jr. Make Gifts to Petitioners?", petitioners make the following statment:

> Although it is Jamison's immediate problem, petitioners know of no action or event, delivery, notice, or otherwise, usually required in the making of a completed gift, that Jamison has taken or participated in involving Grant stock or the petitioners' notes payable to him, that would constitute a gift, reportable to respondent.

On the basis of the record, the Court is unable to find that there was a gift of $500,000 to the petitioners by R. H. Jamison, Jr. He caused the Grant County Coal Corp. to be organized and transferred certain leases to the corporation, with the expectation that the venture would be successful. He caused the stock to be issued in the names of the petitioners and his business associates without consideration, at which time it must be assumed that the stock had no value. In order to provide working capital for the corporation, Mr. Jamison from time to time issued checks totaling $500,000 in the names of the respective shareholders in order that this amount might be contributed by them to the corporation. Mr. Jamison then took back nonrecourse notes from each of the shareholders secured by their stock.

If the venture had met with success, it must be presumed that Mr. Jamison intended to recoup the amount of his advances from the petitioners. In fact, Mr. Jamison in turn borrowed the sum of $500,000 from the Mellon National Bank & Trust Co., further evidencing an intent

on his part that the petitioners would ultimately be able to repay the $500,000 which he had advanced to them; and Mr. Jamison would in turn repay his loan to the bank.

Mr. Jamison's intent to recover his loan of $500,000 from the petitioners is further evidenced by the fact that he did not report the amounts loaned to them as gifts for purposes of the internal revenue laws.

In the absence of any proof to the contrary, the transaction speaks for itself. It was Mr. Jamison's intent to make a nonrecourse loan to the petitioners and not a "gift." As an experienced coal operator, Mr. Jamison obviously felt that he would be able to make some money for them from the operations of the Grant County Coal Corp. and get his money back.

This Court found that the petitioners, and not Mr. Jamison, were the real shareholders of Grant County Coal Corp. As such, petitioners made a valid election to be taxed under subchapter S of the Code (sec. 1372). Pursuant to such election, petitioners were chargeable with their pro rata share of the net taxable income and operating losses of the corporation (secs. 1373-1374). With respect to the losses allowed, however, section 1374(c)(2) provides, as follows:

> (2) LIMITATION.--A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of--

(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

The losses deductible by petitioners were thus limited to the adjusted basis of their stock of the corporation. At the outset, such basis was a nominal amount or "zero."

In order to provide working capital for the corporation, Mr. Jamison gave the petitioners checks from time to time, as needed, totaling $500,000, which were endorsed over by them as contributions to the capital of the corporation. Petitioners executed a series of nonrecourse notes with the stock as collateral to evidence this indebtedness. Except for the contributions to capital obtained in this manner, petitioners would not have been entitled to deduct the losses of the corporation in the first instance. The respondent's disallowance of such deductions would have been sustained by the Court.

In reliance on the rule enunciated by Crane v. Commissioner, 331 U.S. 1 (1947), this Court held that petitioners were entitled to include as a part of their adjusted basis within the meaning of section 1374(c)(2) the respective contributions to the capital of the corporation made out of "borrowed" funds. To the extent of such contributions, the petitioners received the benefit of deducting the losses sustained by the corporation.

At the time that these "loans" were contributed to the corporation, it cannot be said that the value of petitioners' stock which was pledged to secure the loans equaled or exceeded the amount of the indebtedness. In fact, the contributions were made to enable the corporation to continue in business notwithstanding recurring losses.

The term "adjusted basis" is defined by the statute. Neither the statute nor the Crane case would deny the petitioners the right to increase their basis in this stock on account of the amounts contributed, regardless of the source of the funds. See sec. 1.118-1, Income Tax Regs.

When it became apparent that the corporation faced bankruptcy, Mr. Jamison took the necessary steps to reacquire the stock in accordance with the terms of the notes. These steps amounted to a "foreclosure." Such a foreclosure would constitute a sale or exchange of the surrendered stock. Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Co. v. Commissioner, 311 U.S. 513 (1941). In the sale or exchange of such stock, petitioners had a gain to the extent that the amount realized, in this case the amount of the extinguished indebtedness, exceeded the adjusted basis of the surrendered stock. Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Woodsam Associates, Inc., 16 T.C. 649, affd. 198 F.2d 357 (2d Cir. 1952); Mendham Corp., 9 T.C. 320 (1947); Lutz & Schramm Co., 1 T.C. 682 (1943). This Court has held that this result follows regardless of whether the value of the property surrendered is less than the amount of the obligation. Mendham Corp. supra; Lutz & Schramm Co., supra./2

In our opinion, the value of the stock was immaterial. Petitioners had received a cash equivalent in the amount of the notes, whether they were personally liable on such notes or not.

/2 This result has also been suggested by a number of commentators. For discussion of this result, see Ginsburg, "The Leaky Tax Shelter," 53 Taxes 719, 730 (1975); Adams, "Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion," 21 Tax L. Rev. 159 (1966); Spears, "Mortgages in Excess of Bases," 11 U. So. Cal. Tax Inst. 883 (1959).

Parker v. Delaney, supra; Mendham Corp., supra. Unlike the Court of Appeals, this Court would not, however, conclude that the stock was "worthless" when it was surrendered to Mr. Jamison. It had a value to Mr. Jamison, particularly, since as sole stockholder he would be able to deduct the anticipated losses which would be incurred in winding up the affairs of the corporation. The transaction amounted to more than the acquisition by foreclosure of a worthless piece of paper.

Finally, the Court of Appeals suggested a discussion of petitioners' alternative reliance on the so-called purchase-money exception to the cancellation-of-indebtedness doctrine./3 Suffice to say, the facts in this case do not present a situation where the parties got together and agreed upon a reduction in the price of property sold by one to the other. The satisfaction of the notes came about strictly in accordance with the terms of the original loans. Mr. Jamison exercised his right to foreclose.

Although not directed to do so, the Court has also reconsidered whether

/3 It should be noted that petitioners cited in support of this contention, Helvering v. A. L. Killian, Co., 128 F.2d 433 (8th Cir. 1942); Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940); Charles L. Nutter, 7 T.C. 480 (1946); Gehring Publishing Co., 1 T.C. 345 (1942). All these cases were decided before the Crane decision.

Robert K. Conrad, petitioner in docket No. 5893-72, has sustained his burden with respect to proof of error by the respondent in assessing the penalty under section 6653(a). In sustaining the penalty, the Court took cognizance of the fact that Mr. Conrad had been a tax practitioner for many years. He drew up the documents pursuant to which Mr. Jamison reacquired the stock by foreclosure. At another point, Mr. Conrad claimed that the petitioners were, in fact, stockholders throughout the calendar year 1967 and right up to the trial. Apparently, Mr. Conrad adopted this position to justify his failure to include in his return for the taxable year 1967 the recapture of the investment tax credit under section 47. At the same time, he prepared a return for Mr. Jamison for the calendar year 1967 in which Mr. Jamison claimed the deduction of the net operating loss of Grant County Coal Corp. for the taxable year 1967, as its sole stockholder. On the whole, the Court concluded that the actions by Mr. Conrad exhibited the intentional lack of regard for the law and regulations upon which the statute imposes the penalty.

Accordingly, having reconsidered our opinion in this matter, we find no reason to change our views and, therefore, reaffirm that opinion.

Decisions will be entered in accordance with this opinion.

Reviewed by the Court.

STERRETT, J., concurring: I concur that the full amount of the nonrecourse debt constitutes an amount realized in spite of the fact that the value of the property is less than the amount of the debt. The crux of Crane v. Commissioner, 331 U.S. 1 (1947), is that the taxpayer received a benefit at least equal to the nonrecourse debt. However, the Supreme Court noted that "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." Crane v. Commissioner, supra n. 37. Adherence to the Crane doctrine increases petitioners' basis in their stock, allowing them the benefit of large tax losses from their small business corporation without realizing income when their stock is foreclosed upon. The tax law must not be construed in a vacuum. Petitioners have received a tax benefit of economic substance attributable to the use of their Crane basis. When the property is disposed of, petitioners must account for these deductions.

Wiles, J., agrees with this concurring opinion.

Gavin S. MILLAR, Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5884-72)

John R. JAMISON and Suzon G. Jamison, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5885-72)

Philip D. RODGERS and Elizabeth C. Rodgers, his wife, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5888-72)

Philip R. JAMISON and Helen L. S. Jamison, his wife, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5889-72)

James L. TENLEY and Betty J. Tenley, his wife, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5892-72)

Robert K. CONRAD and Jane H. Conrad, his wife, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 5893-72)
No. 75-2296

United States Court of Appeals,
Third Circuit

Argued June 11, 1976
Decided August 12, 1976

Before SEITZ, Chief Judge and ALDISERT and GARTH, Circuit Judges.

OPINION OF THE COURT

SEITZ, Chief Judge.

This is an appeal from a decision of the Tax Court which held that the petitioner taxpayers realized taxable gain in the form of cancellation of indebtedness upon the surrender of their stock in Grant County Coal Corporation ("Grant County") to R. H. Jamison in complete satisfaction of their non-recourse obligations to him secured by the same, even though their stock had a fair market value of zero at the time of surrender. This case thus raises an issue left open by the Supreme Court's landmark decision in Crane v. Commissioner, 331 U.S. 1, 14 n. 37, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947). In addition, two of the petitioners contest the entry of a negligence penalty against them pursuant to 26 U.S.C. §6653(a) for failure to report as income the gain on the surrender of the Grant County stock and to recapture certain investment credits previously applied by them to reduce their income tax liability.

The relevant facts as found by the Tax Court or stipulated to by the parties may be briefly stated. The petitioners are relatives and/or close business associates or R. H. Jamison, a prominent Western Pennsylvania coal-mine operator. In 1964, Jamison organized Grant County for the purpose of developing a West Virginia strip-mining operation and caused it to issue its stock to the petitioners and four others for no consideration on their part. In order to provide the corporation with working capital,

Jamison advanced $500,000 to Grant County's shareholders/1 in amounts proportionate to their interest in the corporation. Each shareholder then executed a demand, non-recourse note payable to Jamison in the amount previously advanced to him. These notes were secured solely by the shareholders' Grant County stock. Thereafter, the shareholders contributed the funds advanced to them by Jamison to the capital of Grant County which used them to commence mining operations.

The anticipated profits from the Grant County venture never materialized. Instead, the corporation suffered net operating losses of nearly $600,000 in the years 1964 through 1966. By the beginning of 1967, these continuing losses had left Grant County on the verge of bankruptcy and rendered the shareholders' stock therein valueless. At this point in time, Jamison demanded payment on the shareholders' notes. When no such payments were forthcoming, he notified them that he was foreclosing on their stock. Shortly after the foreclosure, Grant County went into bankruptcy.

Despite the absence of profits during the period of Grant County's operation, each of its shareholders secured

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/1 Four of Grant County's original shareholders are not parties to this appeal. Hereinafter, the term "shareholders" shall refer to all of Grant County's original shareholders, and the term "petitioners" only to the shareholders involved in this appeal.

significant tax benefits from his ownership of Grant County stock. Shortly after its incorporation, Grant County's shareholders had filed an election with the Internal Revenue Service ("I.R.S.") to have Grant County taxed as a small business corporation under Subchapter S of the Internal Revenue Code ("I.R.C."). As a result, its net operating losses passed through to its shareholders in proportion to their interest in the corporation and they were entitled to, and did, claim such losses as deductions in computing their personal tax liability. Likewise, the investment tax credits earned by Grant County under 26 U.S.C. §38, during this period passed through to its shareholders because of its status as a Subchapter S corporation. In addition, Grant County paid the interest due on each shareholder's note to Jamison. The shareholders, in turn, claimed these interest payments as deductions on their personal tax returns under 26 U.S.C. §163.

For the petitioners herein, these interest and operating loss deductions enabled them to shelter from federal taxation nearly $298,000 in income earned from outside sources and the investment tax credits claimed reduced their income tax liability by approximately $40,000. However, it should be noted that both the operating loss and interest deductions claimed by the shareholders had the necessary effect of reducing their adjusted bases in the Grant County stock in an amount equal to the deductions taken.

On their 1967 tax returns, none of the petitioners reported any gain on the transfer of their stock to Jamison nor did

they recapture any of the investment tax credits claimed in prior years. The Commissioner of the I.R.S, however, determined that the petitioners had realized taxable gain on the foreclosure in the amount by which their discharged indebtedness exceeded their adjusted bases in the Grant County stock. He also determined that the investment credits were subject to recapture. Accordingly, he entered tax deficiencies against the petitioners. In addition, he assessed a negligence penalty pursuant to 26 U.S.C. §6653(a) against two of the petitioners for failure to report these items. Thereafter, the petitioners challenged the Commissioner's determinations in the Tax Court which for the most part, upheld the Commissioner./2 This appeal followed./3

In concluding that the petitioners had realized taxable gain upon the foreclosure, the Commissioner took the position that, under Crane, the petitioners had realized cancellation of indebtedness income on the surrender of their stock in the amount of their discharged non-re-

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/2 The Commissioner's original determination that the petitioners had realized ordinary income rather than capital gains on the foreclosure was reversed by the Tax Court. However, the Tax Court upheld the Commissioner's actions in all other respects.

/3 The petitioners do not contest the Tax Court's determination that the investment tax credits were subject to recapture.

course obligations. Although the petitioners' original bases in their Grant County Stock equaled the amount of their obligations to Jamison, by the time of foreclosure their adjusted bases in that stock had been reduced below their indebtedness by virtue of the substantial interest and operating loss deductions previously claimed. As the amount of the indebtedness extinguished by the foreclosure thus exceeded their adjusted bases in the stock, the Commissioner determined that they had realized taxable gain in the amount of that excess within the meaning of 26 U.S.C. §1001(a)./4

Of course, the existence of a debtor-creditor relationship between the petitioners and Jamison is a necessary predicate to a determination that the petitioners realized taxable gain on the transfer of their stock. Obviously, if the petitioners had no obligation to repay the funds advanced to them by Jamison, no cancellation of indebtedness income could have thereafter arisen. Despite the appearance of such indebtedness in the instant case, however, one of the positions taken by the petitioners in the Tax Court was that the cash advances made to them were intended as gifts and not as loans. Hence, they maintained that there were never any debts in existence, the discharge of which would generate cancella-

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/4 Section 1001(a) defines gain as the excess of the amount realized upon the sale or other disposition of property over the taxpayer's adjusted basis in that property.

tion of indebtedness income. The petitioners reiterated this contention in their arguments before this Court.

Although the petitioners thus placed in issue the question of whether the Jamison advances constituted gifts or loans, the Tax Court failed to make any specific findings on this threshold matter. Indeed, at one point in its opinion, albeit in the narrow context of determining the petitioners' original basis in the stock, the Tax Court stated that "[i]t is not necessary to determine whether such advances are to be treated as 'debt' or as 'gifts'". However, we fail to understand how the court could have reached the ultimate issue before it without first resolving this question since the petitioners could not have realized any cancellation of indebtedness income on the foreclosure if no debts were in existence. It may be that the Tax Court implicitly resolved this matter in the government's favor in view of its ultimate determination that the petitioners had realized taxable gain on the surrender of their stock. On the other hand, it may be that the court misunderstood the thrust of the petitioners' argument, and, as a result, failed to confront it. However, in view of the threshold importance of this issue, the explicitness with which the petitioners have asserted it both in the Tax Court and on this appeal, and the ambiguous nature of the Tax Court's treatment of it, we believe that the case must be remanded so that the Tax Court may proper-

ly resolve this crucial matter in the first instance./5

Since we have decided to remand this case, it is unnecessary for us to address the petitioners' argument that Crane does not require the inclusion of a discharged non-recourse obligation in the amount realized upon the disposition of property securing the same where, as here, the fair market value of that property is not only less than the debt extinguished, but is, in fact, zero. However, in view of the general importance of this issue to the tax bar and the heavy emphasis placed on it by the parties before this Court, we would expect the Tax Court to directly address it if, upon remand, it determines that the Jamison advances constituted debt. Likewise, in the event the Tax Court resolves the threshold issue in the Commissioner's favor, we believe that some discussion of petitioners' alternative contention concerning the so-called purchase money exception to the cancellation of indebtedness doctrine would be appropriate.

The decision of the Tax Court will be vacated and this case remanded for further proceedings not inconsistent with this opinion.

/5 Of course, in view of our decision to remand on this issue, any resolution of the challenge raised by two of the petitioners to the imposition of the negligence penalty against them would be premature.

UNITED STATES TAX COURT

GAVIN S. MILLAR, ET AL.,/1

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket Nos. 5884-72 - 5893-72

Filed April 22, 1975

MEMORANDUM FINDINGS OF FACT AND OPINION

/1 Cases of the following petitioners are consolidated herewith for purposes of trial, briefs, and opinion: John R. Jamison and Suzon G. Jamison, docket No. 5885-72; John M. Harmon, Jr. and Josephine J. Harmon, docket No. 5886-72; R. H. Jamison, III and Jane P. Jamison, docket No. 5887-72; Philip D. Rodgers and Elizabeth C. Rodgers, docket No. 5888-72; Philip R. Jamison and Helen L. S. Jamison, docket No. 5889-72; Marguerite L. Hawkins, docket No. 5890-72; Alvin D. Hawkins and Marguerite L. Hawkins, docket No. 5891-72; James L. Tenley and Betty J. Tenley, docket No. 5892-72, and Robert K. Conrad and Jane H. Conrad, docket No. 5893-72.

QUEALY, Judge: In his notices of deficiency, as supplemented by his amended answers, the respondent has determined deficiencies in Federal income taxes as follows:

Petitioner	Docket No.	Year	Deficiency	Total
Gavin S. Millar	5884-72	1963	$10,102.31	
		1966	41,643.07	
		1967	65,175.18	$116,920.56
John R. and Suzon G. Jamison	5885-72	1966	22,542.85	
		1967	27,161.83	49,704.68
John M., Jr. and Josephine J. Harmon	5886-72	1966	9,814.20	
		1967	7,608.32	17,422.52
R.H., III and Jane P. Jamison	5887-72	1966	29,687.69	
		1967	34,550.79	64,238.48
Philip D. and Elizabeth C. Rodgers	5888-72	1966	8,977.63	
		1967	11,226.19	20,203.82
Philip R. and Helen L.S. Jamison	5889-72	1966	19,078.54	
		1967	28,079.60	47,158.14
Marguerite L. Hawkins	5890-72	1966	14,183.98	14,183.98
Alvin D. and Marguerite L. Hawkins	5891-72	1967	10,364.90	10,364.90
James L. and Betty J. Tenley	5892-72	1966	8,116.52	
		1967	10,303.85	18,420.37
Robert K. and Jane H. Conrad	5893-72	1963	6,781.76	
		1966	59,220.57	
		1967	56,877.42	122,879.75
				$481,997.20

As regards Robert K. and Jane H. Conrad, the respondent determined an addition to the tax for the taxable year 1967 in the amount of $2,843.87 pursuant to section 6653(a)./2

/2 All statutory references are to Internal Revenue Code of 1954, as amended, unless otherwise indicated.

The deficiencies determined by the respondent are a result of certain transactions relating to the ownership of the stock of Grant County Coal Corp. The principal questions for decision are as follows:

(1) Whether the net operating losses of Grant County Coal Corp. for the taxable years 1964 to 1967, inclusive, are deductible in whole or in part by the petitioners.

(2) Whether the petitioners realized income when the stock of Grant County Coal Corp., which was held as security for the payment of a total of $500,000 contributed to the capital of said corporation, was taken over by the lender in accordance with the terms of said loans.

(3) Whether there was a sale or other disposition by the petitioners of the stock of Grant County Coal Corp. on account of which there resulted a recapture of the investment tax credit under section 47.

FINDINGS OF FACT

Some of the facts have been stipulated by the parties. Such facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioner Gavin S. Millar filed Federal income tax returns for the taxable years 1963, 1966, and 1967 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioner's place of residence was Pittsburgh, Pennsylvania.

Petitioners John R. Jamison and Suzon G. Jamison filed joint Federal income tax returns for the taxable years 1966 and 1967 and an amended Federal income tax return for the taxable year 1966 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioners' place of residence was Greensburg, Pennsylvania.

Petitioners John M. Harmon, Jr., and Josephine J. Harmon filed joint Federal income tax returns for the taxable years 1966 and 1967 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioners' place of residence was Bridgeville, Pennsylvania.

Petitioners R. H. Jamison, III and Jane P. Jamison filed separate Federal income tax returns and an amended Federal income tax return for the taxable year 1966 with the district director of internal revenue, Pittsburgh, Pennsylvania. For the taxable year 1967, they filed a joint Federal income tax return with said district director. At the time of the filing of the petition herein, petitioners' place of residence was Greensburg, Pennsylvania.

Petitioners Philip D. Rodgers and Elizabeth C. Rodgers filed joint Federal income tax returns for the taxable years 1966 and 1967 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioners' place of residence was Greensburg, Pennsylvania.

Petitioners Philip R. Jamison and Helen L. S. Jamison filed a joint Federal income tax return for the taxable year 1966 with the district director of internal revenue, Parkersburg, West Virginia. For the taxable year 1967, they filed a joint Federal income tax return with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioners' place of residence was Barrett, West Virginia.

Petitioner Marguerite L. Hawkins filed a Federal income tax return for the taxable year 1966 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein (docket No. 5890-72), petitioner's place of residence was Roanoke, Virginia. Marguerite L. Hawkins, formerly Marguerite L. Jamison, was married to Alvin D. Hawkins in the year 1967.

Petitioners Alvin D. Hawkins and Marguerite L. Hawkins filed a joint Federal income tax return for the taxable year 1967 with the Internal Revenue Service Center, Cincinnati, Ohio. At the time of the filing of the petition herein (docket No. 5891-72), petitioners' place of residence was Roanoke, Virginia.

Petitioners James L. Tenley and Betty J. Tenley filed joint Federal income tax returns for the taxable years 1966 and 1967 with the district director of internal revenue, Louisville, Kentucky. At the time of the filing of the petition herein, petitioners' place of residence was Pikeville, Kentucky.

Petitioners Robert K. Conrad and Jane H. Conrad filed joint Federal income tax returns for the taxable years 1963, 1966, and 1967 with the district director of internal revenue, Pittsburgh, Pennsylvania. At the time of the filing of the petition herein, petitioner Robert K. Conrad's place of residence was Moorewood Avenue, Pittsburgh, Pennsylvania, and petitioner Jane H. Conrad's place of residence was Bayard Street, Pittsburgh, Pennsylvania.

R. H. Jamison, Jr., is a member of a prominent Westmoreland County, Pennsylvania, coal mining family. From about 1935 to March 1, 1966, he was the owner-operator of corporations operating strip and deep mines in western Pennsylvania and West Virginia, the best known and most successful of which was Delmont Fuel Co., Hunkers, Pennsylvania, sold to Eastern Gas & Fuel Associates on February 28, 1966.

By agreement dated January 31, 1964, Delmont Fuel Co. acquired an option to purchase the equipment and leases of a coal mining property constituting the strip mining operation of White Crest Coal Corp. near Mount Storm, Grant County, West Virginia. Following an engineering study, on May 6, 1964, Delmont Fuel Co. notified the sellers that it would not exercise the option. Thereafter, on May 27, 1964, R. H. Jamison, Jr. (hereinafter sometimes referred to as "Jamison") obtained an extension of the option in his own right. By the extended date he completed a purchase agreement of the equipment and leases.

On July 28, 1964, Jamison caused to be organized the Grant County Coal Corp. (hereinafter referred to as "Grant County"), with its principal office and place of business at Mount Storm, West Virginia. Upon the incorporation of Grant County, the purchase agreement regarding the equipment and coal properties of White Crest Coal Corp. near Mount Storm, West Virginia, was acquired by Grant County. The original shareholders of record and the shares issued in the name of each were as follows:

Name	No. of Shares	No. of Certificate
Gavin S. Millar	19.5	1
Robert K. Conrad	19.5	2
R.H. Jamison, III	11	3
John R. Jamison	11	4
Philip R. Jamison	11	5
Josephine J. Harmon	6	6
Mary J. Boneno	6	7
R.H. Jamison, Jr., as custodian for Marguerite L. Jamison (now Hawkins)	6	8
James L. Tenley	5	9
Philip D. Rodgers	5	10
TOTAL	100	

R. H. Jamison, III, John R. Jamison, and Philip R. Jamison are sons of R. H. Jamison, Jr., and at various times were employed by Delmont Fuel Co., providing

them with training and experience in the coal industry. Josephine J. Harmon and Marguerite L. Hawkins are daughters of R. H. Jamison, Jr. The third daughter of R. H. Jamison, Jr., Mrs. Barry Boneno, is not a party to this action.

Gavin S. Millar, a former Federal bank examiner and presently President of the First National Bank of Youngwood, Pennsylvania, had been employed by R. H. Jamison, Jr., in a financial capacity, primarily as Vice President and Treasurer of Delmont Fuel Co., and, for the periods here involved, was President of Grant County.

Philip Rodgers is a brother-in-law of R. H. Jamison, Jr., and a long-term supervisory employee of Delmont Fuel Co.

James L. Tenley, a mining engineer, was a long-term supervisory employee of Delmont Fuel Co.

R. K. Conrad, a certified public accountant and tax practitioner, has served R. H. Jamison, Jr., and his controlled coal mining corporations in professional and advisory capacities since 1943.

On August 27, 1964, Grant County filed an election to be taxed as a subchapter S corporation pursuant to section 1372. The shareholders of record duly signified their consent to such election.

During the period from July 28, 1964 to December 20, 1965, Jamison borrowed a total of $500,000 from the Mellon National Bank and Trust Co. (hereinafter referred

to as the "Mellon Bank") in order to provide capital for the operations of Grant County. The amounts thus borrowed by Jamison were, in turn, transmitted to each of the shareholders of Grant County, in proportion to their ownership of the stock of that corporation, for contribution by them to the capital of Grant County. Each of said shareholders simultaneously executed an assignment of their stock of Grant County to Jamison and a series of nonrecourse demand notes for the amounts advanced by Jamison and contributed to the capital of said corporation.

Gavin S. Millar's assignment, the language of which is the same for the other shareholders except as to the maker, the amount of stock, and the certificate number, is as follows:

> FOR VALUE RECEIVED, I Gavin S. Millar hereby sell, assign and transfer unto Richard H. Jamison, Jr. Nineteen and one-half (19.5) Shares of the Capital Stock of the Grant County Coal Corporation standing in my name on the books of said corporation represented by Certificate No. 1 herewith and do hereby irrevocably constitute and appoint the said Richard H. Jamison, Jr., my attorney to transfer the said stock on the books of the within named Company with full power of substitution in the premises.
>
> Dated July 28, 1964

Gavin S. Millar's note of July 28, 1964, the language of which is the same for the other shareholders, and for the other dates, except as to the maker, the amount advanced, and the amount of stock is as follows:

$29,250.00 Greensburg, Pennsylvania
July 28, 1964

ON DEMAND after date, I, the undersigned, promise to pay to Richard H. Jamison, Jr. or order, Twenty-nine Thousand Two Hundred Fifty ($29,250.00) Dollars, payable at Greensburg, Pennsylvania, with 5-1/2% interest per annum payable quarter annually from date until paid.

To secure payment of this note and the interest and expenses which may accrue thereon, I have deposited with and delivered to Richard H. Jamison, Jr. 19-1/2 shares of the capital stock of Grant County Coal Corporation represented by Certificate No. 1, registered in my name.

I hereby authorize Richard H. Jamison, Jr. to collect all amounts which may be or become due on the deposited securities and apply any amounts so collected to the note or interest due thereon and endorse on behalf of and in my name said securities and give receipts in my name for any amounts due or becoming due on said securities.

Upon default in the payment of said note or the interest thereon when due, Richard H. Jamison, Jr. or any holder of the note, may at any time or times thereafter sell and make delivery of the said property or any part thereof on any exchange or at any public or private sale without notice, advertisement or demand of any kind and may apply the net proceeds after deducting all costs and expenses of collection, sale and delivery to the payment of this note, or any of said other liabilities connected therewith, returning the residue to me upon my demand. Richard H. Jamison, Jr. or any holder of the note may purchase the property at such public or private sale.

This note and the liabilities hereunder are payable solely and only out of the property hereinabove deposited and delivered without other personal liability on my part.

This note applies to and inures to the benefit of and binds the heirs, executors and assigns of the parties and shall be construed according to the laws of the Commonwealth of Pennsylvania.

IN WITNESS WHEREOF, I, Gavin S. Millar, maker of the above note have executed this note the 28th day of July, 1964.

As a result of the foregoing, the stock registered in the name of each of the shareholders of Grant County was held

by Jamison as security pursuant to the terms of said assignments to secure the obligations represented by said nonrecourse demand notes from the shareholders of Grant County in the amounts and the dates set forth below:

Maker of Note	Date	Amount	Total
Gavin S. Millar	7/28/64	$29,250	
	9/28/64	29,250	
	2/12/65	14,625	
	7/30/65	14,625	
	12/20/65	9,750	
			$ 97,500
R.K. Conrad	7/28/64	$29,250	
	9/28/64	29,250	
	2/12/65	14,625	
	7/30/65	14,625	
	12/20/65	9,750	
			$ 97,500
R.H. Jamison, III	7/28/64	$16,500	
	9/28/64	16,500	
	2/12/65	8,250	
	7/30/65	8,250	
	12/20/65	5,500	
			$ 55,000
John R. Jamison	7/28/64	$16,500	
	9/28/64	16,500	
	2/12/65	8,250	
	7/30/65	8,250	
	12/20/65	5,500	
			$ 55,000
Philip R. Jamison	7/28/64	$16,500	
	9/28/64	16,500	
	2/12/65	8,250	
	7/30/65	8,250	
	12/20/65	5,500	
			$ 55,000

Maker of Note	Date	Amount	Total
Josephine J. Harmon	7/28/64	$ 9,000	
	9/28/64	9,000	
	2/12/65	4,500	
	7/30/65	4,500	
	12/20/65	3,000	
			$ 30,000
Mary J. Boneno	7/28/64	$ 9,000	
	9/28/64	9,000	
	2/12/65	4,500	
	7/30/65	4,500	
	12/20/65	3,000	
			$ 30,000
R.H. Jamison, Jr. as custodian for Marguerite L. Jamison	7/28/64	$ 9,000	
	9/28/64	9,000	
	2/12/65	4,500	
	7/30/65	4,500	
	12/20/65	3,000	
			$ 30,000
James L. Tenley	7/28/64	$ 7,500	
	9/28/64	7,500	
	2/12/65	3,750	
	7/30/65	3,750	
	12/20/65	2,500	
			$ 25,000
Philip D. Rodgers	7/28/64	$ 7,500	
	9/28/64	7,500	
	2/12/65	3,750	
	7/30/65	3,750	
	12/20/65	2,500	
			$ 25,000
	TOTAL		$500,000

In addition to the foregoing, Grant County borrowed the sum of $100,000 from the Mellon Bank on May 11, 1966, to purchase certain equipment. Repayment of this loan was guaranteed by Jamison and was secured by a lien on such equipment.

On October 10, 1966, Jamison entered into an agreement with the Mellon Bank whereby all of the stock of Grant County and the notes of the petitioners were assigned and delivered to the Mellon Bank as security for Jamison's loans. Said assignment was solely for the purpose of securing said loans, and did not effect a transfer of the beneficial interest in the stock.

On January 23, 1967, Grant County filed a petition under chapter 11 of the Bankruptcy Act in the District Court for the Western District of Pennsylvania.

On January 27, 1967, Jamison mailed a demand and acknowledgment to each of the petitioners pursuant to the terms of their notes, thereby declaring himself the owner of the shares of Grant County by reason of a foreclosure thereunder. Each of said demands and acknowledgments was signed by the petitioners and returned to Jamison, signifying their consent thereto. As sole stockholder, Jamison thereupon transmitted a consent to the district director of internal revenue at Parkersburg, West Virginia, consenting to the election of Grant County to be taxed pursuant to subchapter S.

On April 11, 1967, Grant County was adjudicated bankrupt. The Mellon Bank

foreclosed on its collateral under the note and security agreement of May 11, 1966, pursuant to which the bank had loaned the sum of $100,000 to Grant County. The collateral was sold, leaving a balance of $10,858 due on account of that loan. All of the unsecured personal property of Grant County was sold by the receiver on June 23, 1967.

On April 17, 1967, Jamison repaid the sum of $500,000 owing to the Mellon Bank on account of the loans procured by him for the benefit of the former shareholders of Grant County. Upon the repayment of such loans, the Mellon Bank returned to Jamison the 100 shares of stock of Grant County and the notes of the shareholders.

During the taxable years 1964 to 1966, inclusive, the interest on the loans procured by Jamison from the Mellon Bank in order to provide the funds for the contribution of capital to Grant County, was paid directly by Grant County. The petitioners, who had signed the notes payable to Jamison in the amount of the contributions to capital on their respective accounts, were carried for interest paid to Jamison upon the payment of such interest by Grant County to the Mellon Bank. The interest paid by Grant County was treated as a withdrawal by petitioners on its books and records and on its income tax returns for the taxable years 1964 to 1966, inclusive.

The amounts deducted by petitioners for such interest on their returns are as follows:

	Amount Deducted in 1964	Amount Deducted in 1965	Amount Deducted in 1966
Gavin S. Millar	$1,126.12	$ 4,349.72	$ 5,931.25
John R. Jamison, et ux	635.25	2,453.69	3,345.83
John M. Harmon, Jr., et ux	346.50	1,338.38	1,825.00
R.H. Jamison, III, et ux	635.25	2,453.69	3,345.84
Philip D. Rodgers, et ux	288.75	1,115.31	1,520.83
Philip R. Jamison, et ux	635.25	2,453.69	3,345.83
Marguerite L. Hawkins	346.50	1,338.38	1,825.01
James L. Tenley, et ux	288.75	1,115.31	1,520.83
Robert K. Conrad, et ux	696.90	4,349.72	5,931.25
	$4,999.27	$20,967.89	$28,591.67

Grant County sustained net operating losses in the years and amounts as follows:

Year	Amount
1964	$ 65,125
1965	50,192
1966	246,423
1967	223,519
	$585,259

Petitioners deducted their pro rata shares of Grant County's net operating losses for the taxable years 1964 through 1966 on their income tax returns for said years as follows:

	Amount Deducted in 1964	Amount Deducted in 1965	Amount Deducted in 1966
Gavin S. Millar	$12,699.40	$ 9,787.52	$ 48,052.41
John R. Jamison, et ux	7,163.77	5,521.16	27,106.49
John M. Harmon, et ux	3,907.51	3,011.55	14,785.36
R.H. Jamison, III, et ux	7,163.77	5,521.17	27,106.48
Philip D. Rodgers, et ux	3,256.25	2,509.62	12,321.13
Philip R. Jamison, et ux	7,163.77	5,521.17	27,106.49
Marguerite L. Hawkins	3,907.51	3,011.55	14,785.35
James L. Tenley, et ux	3,256.25	2,509.62	12,321.13
Robert K. Conrad, et ux	12,699.40	9,787.51	48,052.40
	$61,217.63	$47,180.87	$231,637.24

Millar and Conrad were unable to deduct the full amounts of the losses claimed in the taxable year 1966, and they carried the remainder of such losses back to the taxable year 1963. Millar claimed a carryback net operating loss in the year 1963 in the amount of $25,834.96, which he claimed was comprised of loss of $18,971.02, taxes of $880.49, and interest of $5,983.45. Conrad claimed a carryback net operating loss in the year 1963 in the amount of $27,986.73.

Grant County reported investment credits of $3,573.85 and $79,394.36 on its income tax returns for the taxable years 1964 and 1965, respectively. The investment credits were based upon assets having lives ranging from 4 to 15 years, and the assets were purchased during the years 1964 and 1965. The investment credits were duly reflected on the tax returns of the petitioners in accordance with subchapter S. Grant County reported a net recapture of investment credit on its income tax return for the taxable year 1966 in the amount of $751.22./3 The net recapture reported of $751.22 is comprised of recaptures in the amounts of $3,150.00 and $861.85 for a total recapture of $4,011.85, and investment credits of $56.00, $79.48, $1,724.15 and $1,400.00 for total investment credits of $3,259.63

/3 Grant County incorrectly computed the net recapture to be $751.22. The correct figure is $752.22.

In his notices of deficiency, the respondent determined that the interests of the petitioners terminated in 1967 and that they realized ordinary income from the discharge of indebtedness in the amount of the tax benefits they previously received. He also disallowed their pro rata shares of Grant County's net operating loss for the taxable year 1966. He also determined that the termination of their interests in Grant Gounty caused them to recapture the investment credits passed through to them. As regards petitioners Robert K. and Jane H. Conrad, he determined that they are liable for an addition to tax pursuant to section 6653(a) for their failure to report the termination of Robert K. Conrad's interest in Grant County and for their failure to report the recapture of investment credit.

By amendments to his answers, the respondent determined alternatively that the petitioners' interests in Grant County terminated on October 10, 1966, on the assignment by Jamison to the Mellon Bank and accordingly, that the petitioners realized ordinary income by the discharge of indebtedness in the amount of the tax benefits they had received. Consequently, he determined that the petitioners are not entitled to deduct Grant County's net operating loss for the period October 10, 1966 to December 31, 1966, and that the passed through investment credits must be recaptured as of that date.

OPINION

R. H. Jamison, Jr., was an experienced coal mine operator. He saw an opportunity to acquire a strip mining operation which he anticipated could be developed into a profitable venture. He thereupon evolved a plan pursuant to which the mining property could be developed for the benefit of the petitioners, who were either his children or close business associates, without any investment on their part.

Jamison incorporated Grant County Coal Corp. and caused its stock to be issued to the petitioners and another shareholder without any consideration on their part. Each of such shareholders consented to an election that the corporation be taxed under subchapter S. In order to provide working capital, Jamison proceeded to borrow the needed funds from the Mellon Bank on his own obligation. These funds were then, in turn, contributed to the capital of Grant County in the names of the shareholders in proportion to their respective shares. Each of the shareholders executed nonrecourse notes, secured by the pledge of their stock, to cover the amounts contributed. A total of $500,000 was contributed to the capital of Grant County in this manner.

The strip mining venture proved to be unsuccessful. Grant County sustained net operating losses from the outset. Finally, the corporation went into bankruptcy. As a result, Jamison foreclosed on the nonrecourse notes and took over its stock. He thereupon became sole shareholder of Grant County.

During the taxable years 1964 to 1966, inclusive, the petitioners, as shareholders of Grant County, reflected on their individual tax returns the net operating losses and the investment credits available to them as shareholders of a subchapter S corporation. In addition, petitioners deducted as "interest", the payments which had been made by Grant County on account of the interest owing to the Mellon Bank on the loans which had been obtained in the name of Jamison. Such payments were reflected on the books of the corporation as withdrawals by the shareholders. In other words, the corporation undertook to pay for the shareholders' account the interest due on their notes and, as a matter of convenience, made such payments directly to the Mellon Bank to satisfy the liability of Jamison for interest on his obligations to that bank.

Section 1374 provides that the shareholders may deduct their respective portions of the net operating loss of a subchapter S corporation, subject to the limitations prescribed therein. Section 1374(c)(2) prescribes the following limitation:

> (2) Limitation.--A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of--
>
> (A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

> (B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

With respect to the net operating losses of Grant County, the questions thus presented are whether petitioners were, in fact, shareholders and, if so, whether the basis for their stock exceeded the amount of the net operating losses reflected in their returns.

While the entire transaction was conceived, planned, financed, and executed by Jamison, it does not follow that he should be regarded as owning all the stock of Grant County. The "passive" role of the petitioners in this case was not materially different from that of the other participants in David F. Bolger, 59

T.C. 760 (1973). The petitioners were the shareholders of record. As long as the loan was not in default and the creditor had not foreclosed upon the collateral, the petitioners had the right to exercise the same dominion over the stock, including the right to vote the same, as does any shareholder. Industrial Trust Co. v. Commissioner, 206 F. 2d 229 (C.A. 1, 1953); Finefrock v. Kenova Mine Car Co., 22 F. 2d 627 (C.A. 4, 1927); Wolf v. Citizens Bank & Trust Co. of Southern Pines, 92 F. 2d 233 (C.A. 4, 1937).

The petitioners fully exercised their rights as shareholders. They executed the requisite consents for the corporation to be taxed under subchapter S. They executed the notes pledging their stock as security for contributions to the capital for the corporation. The net operating losses and investment credits of the corporation were reflected in their individual returns. If any of the petitioners had elected to pay off the notes, they would have been entitled to receive their shares of the stock of the corporation free and clear. The mere fact that such stock was pledged to secure indebtedness does not change the character of the transaction.

For all the record shows, petitioners acquired their stock without any consideration. They started out with a zero basis. However, contributions to the capital of the corporation were made for their account totaling $500,000, evidenced by a series of nonrecourse notes and secured by the pledge of their stock.

It is not necessary to determine whether such advances are to be treated as "debt" or as "gifts."/4 As a debt, the amount would be includable in the basis of the shareholders under the so-called Crane doctrine. Crane v. Commissioner, 331 U.S. 1 (1947); David F. Bolger, supra. As gifts, the amounts contributed would likewise become a part of the donees' basis. Accordingly, the total amount of $500,000 contributed to the capital of Grant County for the accounts of the shareholders reduced by the withdrawals charged to their accounts because of the payment of interest, became a part of their adjusted basis for their stock. Since the basis thus computed at all times exceeded their respective portions of the net operating losses of the corporation, the limitations of section 1374(c)(2) do not affect the losses to which the petitioners were otherwise entitled./5

/4 Among the gifts specifically enumerated when the predecessor to sec. 2511 was first enacted as sec. 501 of the Revenue Act of 1932 were transfers of property by a taxpayer to a corporation owned by his children. H. Rept. No. 708, 72nd Cong., 1st Sess., p. 27.

/5 In their brief, the petitioners for the first time advance the argument that they are entitled to proportionate shares of Grant County's 1967 operating losses. Respondent takes the position that this issue has not been properly raised. We agree.

In the event that the loans of $500,000 are held to constitute contributions to the capital of the corporation by the shareholders, the respondent contends that there was a "foreclosure", resulting in a sale or other distribution by the petitioners of their stock on October 10, 1966, when Jamison assigned their notes and the pledged stock to the Mellon Bank as security for his loans. Respondent's argument is predicated on the form of the assignment. This argument is wholly lacking in merit. It is a common practice when a borrower pledges property to secure a bank loan for the borrower to execute an assignment of the pledged property to the lender. The mere execution of such assignment does not constitute a sale or exchange of the pledged property.

On the other hand, it is equally clear that there was a "foreclosure", resulting in a sale or exchange by the petitioners of their stock on or about January 27, 1967, when Jamison duly notified the petitioners that he was taking over the ownership of their stock in payment of the obligations to him. Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Co. v. Commissioner, 311 U.S. 513 (1941). The rule applies irrespective whether the taxpayer is personally liable on the obligations for which the property is pledged. Edward F. C. McLaughlin, 43 B.T.A. 528 (1941). See also Rev. Rul. 67-188, 1967-1 C.B. 216. Woodsam Associates, Inc., 16 T.C. 649 (1951), affd. 198 F. 2d 357 (C.A. 2, 1952); George Hewitt Myers, 3 T.C. 1044 (1944). See also Daniel O'Madigan, Jr., T.C. Memo. 1960-212, 19 T.C.M. 1178 (1960). By the same

token, the stock in the hands of the petitioners was a capital asset. The petitioners had held the stock for more than six months. The contributions to capital likewise antedated the sale or foreclosure by more than six months. Accordingly, the resulting gain which the petitioners realized is taxable as a gain from the sale or exchange of a capital asset held for more than six months.

Having concluded that the petitioners' interest in Grant County terminated on the foreclosure, there remains the question whether the petitioners must recapture the investment credits claimed by them in years prior to 1967.

With respect to the investment credits, section 47(a)(1) provides for a recapture in the event of the disposition of the property on account of which credits were claimed before the expiration of its useful life./6

/6 (a) General Rule.--Under regulations prescribed by the Secretary or his delegate--

> (1) Early Disposition, etc. -- If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in

During 1964 and 1965, Grant County purchased certain section 38 properties having lives ranging from 4 to 15 years. As defined by section 48, section 38 property means tangible personal property and certain other tangible property with respect to which depreciation is allowable and having a useful life of 4 years or more. Section 38 allows the purchaser to apply a direct credit for investment in such property against his income tax liability for the year of purchase. For a subchapter S corporation, section 48(e) directs that the credit shall be apportioned pro rata among the shareholders on the last day of the taxable year.

Grant County reported investment credits available to its shareholders in the amounts of $3,573.85, $79,394.36, and $3,259.63 on its income tax returns for the taxable years 1964, 1965, and 1966. All of the petitioners claimed investment credits against tax based upon the investment credits reported by Grant County.

/6 continued

> the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

Due to the dual nature of a subchapter S corporation, section 1.47-4 (a)(2), Income Tax Regs., provides that investment credits of an electing small business corporation must be recaptured when a shareholder disposes of his stock.

It is clear that before the close of the estimated useful lives of the section 38 properties, the petitioners disposed of their stock in Grant County through the foreclosure. Therefore, since the section 38 property ceased to be section 38 property as to the petitioners at that time, the petitioners must recapture the investment credits passed through to them in prior years. Charbonnet v. United States, 455 F. 2d 1195 (C.A. 5, 1972), affirming 320 F. Supp. 874 (E.D. La. 1971).

The fact that section 1.47-4(a)(2) was not promulgated until after the occurrence of the event which triggered recapture does not change the result. Charbonnet v. United States, supra. See Helvering v. Reynolds, 313 U.S. 428 (1941); Manhattan Co. v. Commissioner, 297 U.S. 129 (1936). Our decision in Henry C. Mueller, 60 T.C. 36 (1973), would in any event require the petitioners to recapture the investment credits on the adjudication of bankruptcy.

In conclusion, the respondent determined that petitioners Conrad are liable for an addition to tax for the year 1967 pursuant to section 6653(a) for their failure to report income and a recapture of investment credit on the disposition of the Grant County stock. Such determination is presumed correct. Robert Conrad,

an experienced tax practitioner, gave no justifiable reason for his failure to reflect the sale or other disposition of the stock on his return. Accordingly, the determination of the respondent as to this issue is sustained.

Decisions will be entered under Rule 155.